BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities and Their Holding Companies and Non-Regulated Affiliates	Rulemaking 05-10-030 (Filed October 27, 2005)

COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON THE OPINION ADOPTING REVISIONS TO (1) THE AFFILIATE TRANSACTION RULES AND (2) GENERAL ORDER 77-L, AS APPLICABLE TO CALIFORNIA'S MAJOR ENERGY UTILITIES AND THEIR HOLDING COMPANIES

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Pursuant to the Rule 14.3 of the California Public Utilities Commission's Rules of Practice and Procedure, the Division of Ratepayer Advocates ("DRA") files these comments in response to the October 10, 2006 Proposed Decision.

I. INTRODUCTION

DRA supports the Commission's extensive efforts to revise and update provisions of Affiliate Transaction Rules. The Affiliate Transaction Rules were originally adopted in Decision (D.) 97-12-088, and subsequently amended.[1] The last of those amendments occurred in 1998—prior to the energy crisis in 2000-2001. The rules were intended to provide protection against the greater risks of conflicts of interests inherent in the holding company structure, but experience and subsequent developments demonstrate the rules need improvement to be effective. The October 10, 2006 Proposed Decision ("proposed

[1] *See* D.98-08-035 and D-98-12-075.

decision") amends the rules to maximize protection of ratepayers served by utilities under a holding company structure.

The proposed decision shows compelling reasons to amend the current rules. Among other factors, the proposed decision recognizes the point made by the Consumer Federation of California's ("CFC") in its comments and workshop statements that the new rules are necessary to offset the potential effects of Public Utilities Holding Company Act ("PUHCA") repeal.[2] To strengthen ratepayer protection following PUHCA repeal, the proposed decision modifies the Affiliate Transaction Rules to "close existing loopholes, primarily by requiring more complete reporting to the Commission of utility-affiliate and utility-holding company communications, prohibiting problematic shared services, and ensuring that a utility's financial integrity is protected from the riskier market ventures of its unregulated affiliates and holding company parent."[3]

At the October 18, 2006 Oral Argument, Respondent utilities and holding companies abandoned their original blanket opposition to any modifications to the Original Rules. Instead, most of the Respondents focused arguments on the proposed revisions to Rules IV C and V G, requiring the reporting of sensitive commercial communications, and prohibiting certain shared services. The Sempra companies, however, took a separate position, advocating an alternative approach: retain the original Affiliate Transaction Rules and add a new rule modeled after provision of a settlement agreement between SDG&E and the Attorney General.[4]

In these comments, DRA addresses the issues related the flow of confidential communications regarding two of the proposed rules: the separation of services (Rule IV) and reporting requirements (Rule V). DRA also discusses Commission and court

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[2] Proposed decision, p. 8.

[3] Proposed decision, p. 9.

[4] Transcript, p. 24, line 24 through p. 25, line12. There is nothing about this settlement in the record of this proceeding other than the statements about it made by Sempra's representative at oral argument. It is DRA' understanding that the settlement provision Sempra referred to requires that in any application or initial response to an OII or OIR by SDG&E or SoCalGas that proposes a change in a service in product offering or capital project, or a new service product offering or capital project, the utility identify any affiliate that may be affected by the proposal. The utility also is required to identify alternatives to the proposal considered in the process.

precedents that support applying affiliate transaction rules to the unregulated holding companies and their unregulated subsidiaries.

II. PROPOSED RULE IV C: REPORTING REQUIREMENTS

A. Rule IV C Is Necessary To Prevent Holding Companies from Serving as A Conduit of Confidential Information

The proposed decision explains the Commission's concern for the "likelihood for preferential treatment, unfair competitive advantage, or the sharing of competitively sensitive confidential information within the partly regulated, mostly unregulated corporate family and the consequences such competitive abuse poses for energy markets and captive ratepayers."[5] New Rule IV C, which requires the utilities to report semi-annually on six commercially sensitive subjects, mitigates this concern.

Respondents argue the Commission's conclusion that there is a need to amend the current rules is based on unsupported assertions. At oral arguments, Bill Reed, senior vice president regulatory affairs for SDG&E and Southern California Gas Company, insisted the audits officially noticed in the proposed decision cite mere "technical violations."[6] Thus, while the audits concluded that violations of the rules occurred, Mr. Reed argued that they "did not dispute the SDG&E's assertion that there was no harm to customers, that there was no harm to the market, that there was no benefit to any affiliate."[7] Moreover, because these are self-reported incidents, SDG&E claims this is evidence that the Original Rules are effective to ferret out potential problems.[8]

However, Respondents' arguments do not address the fact that the audits refer to real problems regarding the utility/holding company structure, and that these problems appear to be continuing concerns. Their attempt to trivialize these violations as "technical violations" ignores the audits cited by the proposed decision. These audits

[5] Proposed decision, p. 8.

[6] Transcript of October 18, 2006 Oral Argument ("Transcript"), p. 27, lines 19-21.

[7] Transcript, p. 27, lines 24-28.

[8] Transcript, p. 28, lines 3-6.

concluded that SDG&E's joint utilization of risk management as a shared service resulted in the transfer of confidential information from the utility and the unregulated affiliate, Sempra Energy Trading.[9] The proposed decision also described in another instance how the Commission attempted to impose a remedy (a delay in the transmittal of confidential information from the utility to the holding company), but a 2004 audit found this requirement often was ignored.[10] The harm to ratepayers is clear—the exchange of confidential information negatively impacts market competition, which is supposed to keep costs down for ratepayers. During oral argument, TURN provided a good example of the type of harm that can occur: the CEOs of the utility and its holding company discuss the need for peaker plants at a specific location—six months later, a utility affiliate is proposing to build a peaker plant at the same location.[11] As TURN explained, the affiliate may win the competitive solicitation even at a higher bid, simply because it was privy to key, confidential information of the desired location.[12] Moreover, the procurement review groups and independent evaluators, which help facilitate the competitive process, are unlikely to find out about such communications, and therefore would remain in the dark about the resulting harm. The risk is real that the Commission would remain in the dark too.

DRA believes that requiring semi-annual reports will deter the types of potentially collusive interactions that the holding company structure promotes. Respondents express concern about unintended consequences, including the threat of litigation based on ex post facto interpretation of the notes that the semi-annual report would generate.[13] However, the Commission's obligation to protect ratepayers and the competitive market outweighs the companies' concern. Rule IV C provides sufficient notice, through the list of six commercially sensitive topics, of exactly what types of communications must be

[9] Proposed decision, p. 10, footnote 10.

[10] Proposed decision, p. 11, footnote 10.

[11] Transcript, p. 68, p. 14-24.

[12] Transcript, p. 71, lines 22-27.

[13] Transcript, pp. 47-48.

approached with extra caution. The reporting requirements do not prohibit the companies from communicating on these subjects,[14] and would not impede the utility from complying with other Commission and Federal directives. The rule will provide the Commission with a window into the utility/holding company relationship, so as to "ensure that the utilities do not favor or otherwise engage in preferential treatment of their affiliates."[15]

B. Reporting Requirements Are Less Burdensome Than Utilities Assert

Al Fohrer, chief executive officer of Southern California Edison Company, made statements on the practical implications of proposed Rule IV C would have on everyday operations. At oral argument, he stated, "I would not want to be in a position that I'm going to spend half my day taking minutes of who I've talked to and what I've said."[16] Respondents instead suggest deleting proposed Rule IV C and have the Commission "believe in the integrity of the men and women who work in the holding companies, who work in the utilities."[17]

The integrity of individual utility employees is not the issue in this rulemaking. It has long been recognized that the structure of the utility holding company creates the potential for perverse incentives to engage in self-dealing and cross-subsidization at ratepayer expense. The synergies between regulated and unregulated affiliates that make the utility holding company structure attractive to shareholder interests also create the potential for abuses. Simply "trusting" holding company employees to "do the right thing," as Respondents suggest, would require this Commission to abdicate its ratepayer protection responsibilities. The more responsible regulatory response is the one adopted by the proposed decision. Rule IV C's reporting requirements will assist the Commission

[14] Proposed decision, pp. 19-20.

[15] Proposed decision, p. 21.

[16] Transcript, p. 36, line 24-26.

[17] Transcript, p. 76, lines 20-22.

in ensuring that affiliate transactions are equally fair to ratepayers, shareholders and competitors.

Further, DRA believes the reporting requirements are not as burdensome as the utilities allege. Rule IV C only pertains to six specific, limited subjects: information supplied by the affiliate's competitor; negotiations with the affiliate's competitor; utility procurement plans; utility operational matters; expansion plans; and the affiliate's competition with other entities.[18] The utilities are afforded flexibility on how to comply with the semi-annual report. Moreover, the draft rules further allow an exception for information exchanged in the provision of corporate support services as permitted by Rule V E, as these have been determined by the Commission to carry low risk of unfair competitive advantage.[19] DRA recommends that the Commission to adopt the semi-annual reporting requirements as part of its responsibility to ensure fair competition in energy markets.

III. PROPOSED RULE V E: SEPARATION OF SHARED SERVICES

DRA agrees greater structural separation as contemplated in Rule V E of the proposed rules should also be retained in the final decision. The revision to Rule V E to permit the shared services of certain legal fields (e.g., taxes) is also appropriate, as is certain defined areas of financial planning and analysis (e.g., cash management, banking relations, and communications with rating agencies) that do not give any affiliate an unfair competitive advantage.

The proposed decision also amends Rule V G, which provides that unless a utility receives express authorization from the Commission, utilities are prohibited from jointly retaining contractors or consultants with its holding company or affiliate. The proposed rules would allow auditors and providers of accounting services that conduct independent audits.[20] Respondents opposed the rule during oral argument, stating that the majority of

[18] Draft Affiliate Transaction Rule IV.C.; Proposed decision, p. 19.

[19] Draft Affiliate Transaction Rule IV.C., page 9; Proposed decision, p. 22.

[20] Draft Affiliate Transaction Rule V G; Proposed decision, p. 21.

those entities are not management consultants, but technical consultants.[21] As an example, Respondents refer to the utilities' common use of GE turbines—proposed Rule V G would prohibit the mutual use of a GE consultant or contractor. However, even when it appears the utilities do not have adverse interests involved, the Commission should decide whether there is a potential conflict based on the particular facts involved. Therefore, DRA opposes the blanket exception requested by Respondents. The proposed rules allow for exceptions to be made by application to the Commission in appropriate circumstances. This exception provision creates flexibility, which is desirable, while ensuring that the Commission fulfills its ratepayer protection responsibility by deciding whether, based on the specific services to be shared, there is a potential conflict or not. This requirement to seek exemption on a case by case basis from the rule rather than providing a blanket exemption is also consistent with the pre-approval process required in proposed Rule III B.

IV. THE COMMISSION'S AUTHORITY TO MAKE THESE RULES APPLICABLE TO THE HOLDING COMPANIES IS CLEAR

The proposed decision should make clear the Commission's authority to regulate the flow of confidential information supplied by a utility to a parent company. As highlighted by the proposed decision, the unregulated holding companies routinely find ways to exempt themselves from the original affiliate transactions rules since they do not directly participate in energy markets.[22] The proposed decision is correct in modifying the rules to close certain loopholes regarding the applicability to holding companies. In applying Rules II B and II C directly to the holding company, the final decision should rely on the following authorities.

When the utilities applied to be reorganized under a holding company structure under sections 854 and 818 of the Public Utilities Code, the Commission approved their applications, but imposed certain conditions intended to protect the public interest, and

[21] Transcript, p. 43.

[22] Proposed decision, p. 15.

required that the newly formed holding company agree to those conditions.[23] In D.02-01-037 (*Decision On Motions To Dismiss For Lack Of Jurisdiction*), the Commission held that the conditions provided jurisdiction over the holding companies are valid Commission Orders and are enforceable in Commission proceedings.[24] The Decision affirmed the Commission's authority to impose conditions on non-utility affiliates doing business with utilities in carrying out the statutory duty to protect the public.[25]

Subsequently, the Court of Appeals, First Appellate District, held the Commission could enforce the conditions even in the absence of express statutory authority to regulate holding companies. In *PG&E Corp. v. California Public Utilities Commission; Office of Ratepayer Advocates, et al.,* 118 Cal. App. 4th 1174 (2004), the court concluded that the disputed conditions were germane to aspects of the Commission's regulatory authority over the utilities and were enforceable under section 701 of the Public Utilities Code.[26] Likewise, the Affiliate Transaction Rules are part of a comprehensive regulatory scheme that stems from the original holding company conditions, the first priority condition, and other applicable Commission rules and state statutes that govern the holding company structure. The Commission has full authority to adopt these rules and to modify them, as appropriate, to protect and balance the interests of ratepayers, shareholders and competitors operating in California under utility holding company structures.

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[23] *See* D.88-01-063, 27 CPUC 2d 347, 374 (1988) (approving SCE's application to reorganize under a holding company structure); D.95-12-018, 62 CPUC 2d 626, 635 (1995) (approving SDG&E's holding company structure); and D.96-11-017, 69 CPUC 2d 167, 181, 185 (1996); D.99-04-068, 86 CPUC 2d 76 (1999) (approving PG&E's holding company structure).

[24] D.02-01-037, 2002 Cal. PUC LEXIS 7, p. *10.

[25] *Id*. at p. 10.11; *Henderson v. Oroville-Wyandotte Irrigation District*, 213 Cal. 514 (1931) (The court held that although the Commission lacked general regulatory jurisdiction over the District because it was not a utility, the conditions *were* binding Commission orders, because the Commission did have limited jurisdiction to impose those conditions. n33 The Supreme Court held that although no statute expressly granted the Commission authority to regulate the non-utility, "in approving or authorizing such a sale, the Railroad Commission *has jurisdiction* to impose such conditions as will in the judgment of the Railroad Commission protect and safeguard the pre-existing rights of those entitled to service under [the selling] public utility.")

[26] Section 701 allows the Commission to "do all things ... necessary and convenient" in the exercise of its authority over public utilities whether or not "specifically designated" in the Public Utilities Code.

Respectfully submitted,

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October 30, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON THE OPINION ADOPTING REVISIONS TO (1) THE AFFILIATE TRANSACTION RULES AND (2) GENERAL ORDER 77-L, AS APPLICABLE TO CALIFORNIA'S MAJOR ENERGY UTILITIES AND THEIR HOLDING COMPANIES** in **R.05-10-030** by using the following service:

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Executed on October 30, 2006 at San Francisco, California.

/s/ ALBERT HILL

Albert Hill

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